Office of Chief Counsel
Internal Revenue Service
memorandum

CC:W:DEN:TL-N-7379-98
MSHeroux

date:

to: Linda Novak, Manager International Group E:2:15

from: District Counsel, Denver

subject: [redacted]

Your office has requested advice regarding intellectual property rights transferred in [redacted].

ISSUES

1. What intellectual property did [redacted] ("the taxpayer") acquire in [redacted] from its parent corporation, [redacted]? Does the intellectual property have value in [redacted]? What affect does this property have on the transfer price for [redacted] sold by [redacted] to the taxpayer during the fiscal year ending [redacted]?

2. What is the tax affect of the consideration of $[redacted] paid by the taxpayer for the intellectual property?

CONCLUSIONS

1. In [redacted], the taxpayer acquired intellectual property rights relating to the use and sale of the [redacted] in North and South America and, for the purposes of such use and sale, the right to manufacture [redacted] in [redacted] and (subject to approval) in North and South America. The rights acquired included subsequent developments made by the [redacted] and the [redacted] but did not include subsequent developments made by [redacted]. The rights acquired by the taxpayer have significant value in [redacted], as the [redacted] sold in [redacted] is substantially the same product as that which was sold in [redacted]. The tax affect of owning these property rights is to reduce the transfer price otherwise charged to the taxpayer by [redacted]. Based on the [redacted] transfer pricing report, we cannot determine whether adequate value is attributed to the taxpayer's intellectual property.

[redacted]

2. Payments for intellectual property rights relating to the [redacted] are royalty payments under Article [redacted] of the [redacted]-United States Income Tax Treaty which are subject to withholding under I.R.C. § 1442.

FACTS

The [redacted] was initially developed by the [redacted] and the [redacted]. The [redacted] consists of the [redacted], a [redacted] and a [redacted]. A programming device, the [redacted] is a related piece of equipment used by [redacted] to individually program the patient's [redacted] [redacted] is directed to a very specific market, the [redacted] namely children and adults for whom [redacted] are of little or no value.

On [redacted], [redacted] and the [redacted] executed a License Agreement with [redacted], ("[redacted]"), where at Clause 2.1:

> [redacted] and the [redacted] hereby grant to [redacted] the exclusive right and authority and license to the know-how and licensed patents described in the annexed Schedule 'A' (including utility models, patents of addition, and patents of importation, and patents of confirmation corresponding to said licensed patents and to any and all continuing and divisional applications and extensions and reissues thereof and any foreign equivalents thereof) to manufacture [redacted] in [redacted] and subject to Clause 2.3 outside [redacted] and to use and sell [redacted] in all countries of the world.

The License Agreement provided that subsequent developments made by [redacted] or the [redacted] would be included within the scope of the license. In consideration for the license, [redacted] agreed to pay royalties to [redacted] and the [redacted] equal to [redacted] percent of the royalty base (roughly net sales price to unrelated third-parties) for the first [redacted] units sold and thereafter [redacted] percent on each unit sold.

On [redacted], a Deed of Novation was executed by [redacted], the [redacted], [redacted] and [redacted]. This agreement substitutes [redacted] for [redacted] as licensee under the original [redacted], agreement, and adds [redacted] patents apparently owned by [redacted] to the license. *See and compare* Schedules A attached to the License Agreement and the Deed of Novation.

On [redacted], an Assignment Deed (effective [redacted]), was executed by [redacted], [redacted], the [redacted], and [redacted]s subsidiary, the taxpayer, wherein certain rights were assigned by [redacted] to the taxpayer. The rights in the original License Agreement, as well as additional rights to [redacted] intellectual property owned by [redacted] as of the date of the assignment, were transferred to the taxpayer to the extent that these rights relate to the use and sale of [redacted] in North and South America and, for the purposes of such use and sale, the right to manufacture [redacted] in [redacted] and (subject to the [redacted]'s consent) in North and South America. *See* clause 1.1 of the Assignment Deed. The Assignment Deed did not include intellectual property "subsequent development" language similar to that included in the original License Agreement. In consideration for the assignment of rights, the taxpayer agreed to pay the fair market value of the rights as calculated by [redacted] ($[redacted] U.S. dollars). The taxpayer borrowed the $[redacted] from [redacted] and repaid the loan by [redacted] The taxpayer amortized the $[redacted] over a ten year period based on the remaining life of the assigned patents, reducing gross income by $[redacted] in each year.

Due to [redacted]'s inability to obtain approval from [redacted] and the [redacted] to manufacture [redacted] outside of [redacted] a Manufacturing Sublicense Deed was executed by the same parties on the same day with the same effective date. In the Sublicense Deed, [redacted] acknowledged the taxpayer's ownership of [redacted] intellectual property to the extent that the intellectual property rights relate to the use and sale of [redacted] in North and South America and the manufacture of [redacted] in [redacted] and in North and South America. The sublicense grants [redacted] the right to manufacture [redacted] in [redacted] for use and sale by the taxpayer in North and South America. [redacted] did not pay any consideration for the right to manufacture [redacted] in [redacted] for use and sale in North and South America. The sublicense further states that each item forming part of the [redacted] sold by [redacted] to the taxpayer shall be sold at the price or prices periodically determined by [redacted] and the taxpayer.

[redacted] commissioned [redacted] to value the rights assigned to the taxpayer. [redacted] issued its valuation on [redacted] The valuation acknowledges that the taxpayer owns the intellectual property for use and sale of [redacted] in North and South America and the manufacturing rights for such use and sale. The report further states that based on the Sublicense Deed, [redacted] acts as a contract manufacturer for production of [redacted] for the taxpayer; and that [redacted] should receive a price of cost plus [redacted]% for its contract manufacturing efforts. The method used to value the transferred intellectual property was the royalty savings approach. Sales projections were made from [redacted] to [redacted] ($[redacted] in [redacted] escalating to $[redacted] in [redacted]), and then a royalty savings rate was applied to these sales. The resulting figure was then subject to a discount rate, a risk-free rate, a market risk premium, an industry risk factor, and several other factors to arrive at the fair market value of the assigned rights. Based on its calculations, [redacted] determined that the value of the assigned rights was $[redacted]

From [redacted] through the [redacted] fiscal year the price charged to the taxpayer for the [redacted] was cost plus [redacted]%. The [redacted]% royalty payable under the original License Agreement was also passed on to the taxpayer. During the [redacted] fiscal year, the amount charged by [redacted] to its Japanese subsidiary for [redacted] was cost plus [redacted]%; and the amount charged by [redacted] to its European subsidiary was resale price less [redacted]%.

It appears that the transaction between [redacted] and the taxpayer was questioned by [redacted] tax authorities. As a result, the taxpayer contracted with [redacted] to conduct a transfer pricing study to determine an appropriate transfer price for [redacted] sold to [redacted]'s subsidiaries. The [redacted] report finds faults with the [redacted] report:

1) [redacted] is not a contract manufacturer in that it performs significant R&D which expenses are not passed on to the taxpayer, and therefore [redacted] should receive more than cost plus [redacted]% for its efforts;

2) [redacted]'s valuation of intellectual property rights was based on projected sales which far exceeded actual sales. Using actual sales figures reduces the required annual return on the taxpayer's intellectual property investment from $[redacted] to $[redacted] [Note that for purposes of this advice, actual sales figures are available only for FY[redacted] and these appear to be in the amount of $[redacted] dollars versus projected sales of $[redacted] U.S. dollars];

3) The calculation of the arm's length return on the taxpayer's investment should be based on a $[redacted] investment rather than $[redacted], since $[redacted] was paid by the taxpayer for tax benefits (amortization of the intellectual property).

In fact, most product development is performed by [redacted] in [redacted] where R&D costs are deductible at a [redacted]% rate. A small portion of research and development is conducted and paid for by the taxpayer. This includes activities associated with FDA clinical trials, and maintaining a watching brief in the R&D area to monitor significant developments in the U.S. From [redacted] through [redacted] and the taxpayer spent $[redacted] and $[redacted] on R&D, respectively. Each party bears its own R&D costs; [redacted] does not receive payments from its subsidiaries for its R&D expenses. It appears that most patents registered since [redacted] including those for U.S. and other countries, are registered in [redacted]'s name. Only one patent developed since [redacted] is registered in the taxpayer's name. The [redacted] report, however, repeatedly states that the product sold in [redacted] is substantially the same as that which was sold in [redacted]. [redacted] and the taxpayer are responsible for defending the intellectual property in their respective markets. All manufacturing operations are performed by [redacted] in [redacted]. The [redacted] is then distributed world-wide through [redacted] subsidiaries located in the U.S., Europe, and Japan.

[redacted]

The [redacted] report concluded that an adjustment to the transfer price would be necessary to account for R&D costs, [redacted]'s calculation of the annual return on intellectual property based on sales projections that were never reached, and [redacted]'s failure to account for the $[redacted] tax savings payment included in the $[redacted] paid to [redacted]. [redacted] then computed the transfer price starting with the determination that based on a CPM analysis, [redacted]'s subsidiaries should earn operating margins of [redacted]% of sales which is comparable to similarly situated independent distributing companies. The calculation purportedly makes a provision for the taxpayer to receive a return on its intellectual property investment which is reduced from $[redacted] per year allegedly determined by [redacted], to $[redacted] per year. This reduction is caused by using actual sales rather than projected sales, and an intellectual property investment amount of $[redacted] rather than $[redacted]. However, this computation is not detailed, and a review of the [redacted] report does not support a determination of an annual return of $[redacted]. In order to reduce the taxpayer's operating margin from [redacted]% to [redacted]% and to compensate the taxpayer for its intellectual property rights, the price charged the taxpayer for [redacted] required a [redacted]% upward adjustment. The taxpayer's cost of goods sold reported on the [redacted] return was therefore increased by $[redacted].

The Examination Team submits that while subsequent product development is attributable to [redacted], the taxpayer has stated that the actual unit sold in [redacted] is the same unit that was available in [redacted]. In fact, the [redacted] approval of the "[redacted] was lauded by [redacted] as the first true advance in [redacted] technology in more than a decade. The Examination Team submits that subsequent product development was included in the assignment of rights for which the taxpayer paid $[redacted]. An arm's length agreement for the transfer of intellectual property would include subsequent development. They state that the conduct of the parties supports his argument. [redacted] incurred significant R&D expenses but did not pursue payment from the taxpayer because the $[redacted] payment included payment for subsequent research performed by [redacted]. If the transfer did not include subsequent product development, [redacted] would have charged these costs to the taxpayer during years prior to [redacted]. Since the actual unit sold in [redacted] is substantially the same as the unit sold in [redacted], no transfer price adjustment is necessary in FY[redacted].

Alternatively, the Examination Team acknowledges that the $[redacted] payment may not be commensurate with the income attributable to the transferred intellectual property. They agree that an upward transfer price adjustment is warranted, but the warranted adjustment is less than the [redacted]% alleged by the taxpayer. They submit that the comparable profits method should not be used here as the [redacted] transfer of rights transferred valuable intellectual property to the taxpayer. Furthermore, the [redacted] report does not provide detail on the chosen comparable independent distributors; it does not detail the computation resulting in a reduction of the taxpayer's annual return on intellectual property from $[redacted] to $[redacted] and it does not detail the affect on the taxpayer's annual return on intellectual property on the transfer price. Without this information, the IRS cannot agree to the proposed [redacted]% increase to the transfer price.

Finally, the Examination Team contends that the $[redacted] dollar payment is a royalty payment under Article [redacted] of the [redacted]-United States Income Tax Treaty, and is subject to withholding under I.R.C. § 1442.

ANALYSIS

Intellectual Property and Transfer Pricing

Internal Revenue Code section 482 states:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Treasury Regulation § 1.482-4 provides methods to determine taxable income in connection with a transfer of intangible property. Section 1.482-4(a) states:

> The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in this paragraph (a). . . The available methods are--
>
> (1) The comparable uncontrolled transaction method;
> (2) The comparable profits method;
> (3) The profit split method; and
> (4) Unspecified methods described in paragraph (d) of this section.

Regulation § 1.482-4(f) provides special rules for transfers of intangible property. Specifically, §1.482-4(f)(3)(ii) provides rules to identify the owner of an intangible.

Subsection (A) states:

> The legal owner of a right to exploit a legally protected intangible ordinarily will be considered the owner for purposes of this section. Legal ownership may be

acquired by operation of law or by contract under which the legal owner transfers all or part of its rights to another.

Subsection (B) states:

> In the case of intangible property that is not legally protected, the developer of the intangible will be considered the owner. . . . Ordinarily, the developer is the controlled taxpayer that bore the largest portion of the direct and indirect costs of developing the intangible, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible.

Under the doctrine of indivisibility, a contract conveying the exclusive right to make, use and vend an invention in the United States or within a specified area constitutes an assignment of the patent, and any transfer short of that is not an assignment but a license. Dairy Queen of Oklahoma v. Commissioner, 250 F.2d 503, 506 (10th Cir. 1957). *See also* Waterman v. Mackenzie, 138 U.S. 252, 11 S.Ct. 334, 34 L.Ed. 923 (1891); Watson v. United States, 222 F.2d 689 (10th Cir. 1955); Taylor-Winfield Corporation v. Commissioner, 57 T.C. 205 (1971).

Regulation 1.482-5 describes the comparable profits method. The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Section 1.482-5(a)(b)(2) states that:

> For purposes of this section, the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transaction can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

Regulation 1.482-1(c)(1) states that the transfer pricing result must be determined under the method that provides the most reliable measure of an arm's length result.

In the present case, we conclude, and the taxpayer agrees, that the [redacted] Assignment Deed transferred intellectual property rights relating to the use and sale of [redacted] in North and South America and, for the purpose of such use and sale, the right to manufacture [redacted] in [redacted] and (subject to approval) in North and South America.

[redacted]

See the Waterman v. Mackenzie line of cases. Under the terms of the agreements the only intellectual property rights transferred to the taxpayer were those developed as of the date of the assignment, [redacted] and the only subsequent development rights transferred to the taxpayer were those made by the [redacted] and the [redacted].

However, since the product sold in [redacted] was essentially the same product manufactured in [redacted] we conclude that for purposes of transfer pricing for FY [redacted] the taxpayer is the owner of the intellectual property used to manufacture [redacted] for use and sale in North and South America. From the facts before us, however, we cannot determine whether the proposed transfer price is acceptable. We recognize that [redacted] should be compensated for its unreimbursed R&D efforts, and that the value established by [redacted] for the transferred intellectual property may have to be reduced to bring the valuation in-line with actual sales. We do not agree that [redacted]% is the proper operating margin for the taxpayer, as unlike [redacted]'s other subsidiaries, the taxpayer owns the intellectual property used in the manufacture of [redacted]. We do not agree that the valuation of the intellectual property should be based on a $[redacted] purchase price rather than $[redacted]. It is possible that the allowed return on the taxpayer's investment in intellectual property might compensate for deficiencies caused by using an inappropriate operating margin or incorrectly reducing the sales price of the intellectual property. But this cannot be determined without more detail on the comparables used, the calculation of the taxpayer's return on intellectual property investment, and the impact of that calculation on the proposed transfer price. We do conclude that the tax effect of compensating [redacted] for subsequent product development and adjusting the value of the intellectual property so that it is consistent with actual sales, is to increase the transfer price charged by [redacted] to the taxpayer. The tax effect of the taxpayer owning the intellectual property used in manufacturing [redacted] sold in FY [redacted] is a lesser increase in the transfer price charged by [redacted] to the taxpayer.

With respect to the taxpayer's use of the comparable profits method, Treas. Reg. § 1.482-5 does not prohibit the use of the comparable profits method where the tested party owns valuable intangible property. This method can be used if like comparables can be found; however, the value of intellectual property transferred to the taxpayer in [redacted] must receive consideration in arriving at a transfer price. Without details on the comparables used by [redacted] in its report, we cannot comment on whether the CPM used by [redacted] is acceptable.

Royalty

Payments for intellectual property rights made by the taxpayer are royalty payments under Article [redacted] of the [redacted]-United States Income Tax Treaty which are subject to withholding under I.R.C. § 1442. [These royalty payments do not include the original [redacted]% royalty included in the price charged by [redacted] to the taxpayer.] Article [redacted] of the treaty defines royalties, in part, to mean:

> [P]ayments or credits of any kind to the extent to which they are consideration for the use of or the right to use any: (i) copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right; and (ii) industrial, commercial or scientific equipment.

Article [redacted] of the treaty includes as royalties:

> [P]ayments or credits of any kind to the extent to which they are consideration for: (i) the supply of scientific, technical, industrial or commercial knowledge or information owned by any person; and (ii) the supply of any assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of knowledge or information referred to in sub-paragraph (b)(i) or of any other property or right to which this Article applies.

Since the consideration paid by the taxpayer to [redacted] was, in part, for the right to use property covered under the treaty, the amounts paid for the right to use this property represent royalties subject to withholding under I.R.C. § 1442.

If you have any questions regarding this memorandum, please contact Mark S. Heroux at (303) 844-2214 ext. 225.

MARTIN B. KAYE
District Counsel

By: ____________________
JERRY L. LEONARD
Assistant District Counsel

Attachments:
Examination Field Service Advice Request with Exhibits
Exhibit A: [redacted] Group Structure
Exhibit B: License Agreement and Deed of Novation
Exhibit C: Assignment Deed
Exhibit D: [redacted] Valuation
[redacted] Transfer Pricing Report
Manufacturing Sublicense Deed